ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Cedillo | Analyst: Jeff Garnier | Bill Number: AB 1854

Related Bills: See Legislative History | Telephone: 845-5322 | Amended Date: 03/23/2000

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Earned Income Refundable Credit

SUMMARY OF BILL

This bill would:

- provide a refundable Earned Income Credit (EIC) in an amount equal to 15% of the earned income credit allowed by federal law;
- provide that the Franchise Tax Board (FTB) shall train and inform employers regarding how employees may make withholding adjustments to reflect the credit; and
- include the refundable Earned Income Credit in the list of credits that can reduce regular tax below tentative minimum tax (TMT) for purposes of alternative minimum tax (AMT).

SUMMARY OF AMENDMENT

The March 23, 2000, amendment deleted the prior Earned Income Credit language and replaced it with refundable Earned Income Credit language. The amendment also added the training requirement and included the refundable EIC in the list of credits that can reduce regular tax below TMT.

EFFECTIVE DATE

This bill would be effective immediately upon enactment and would apply to taxable years beginning on or after January 1, 2000, and before January 1, 2005.

LEGISLATIVE HISTORY

SB 1421 (2000) proposes a refundable EIC, and AB 2466 (2000) proposes a nonrefundable EIC. AB 2490 (2000) would require employers to notify their employees of the availability of the federal EIC. AB 1370 (1999), which would have required employers to notify their employees of each employee's possible eligibility for the federal earned income credit, was vetoed by the Governor. SB 43 (1997), AB 83 (1997) and AB 470 (1997) each proposed an EIC. SB 43 and AB 470 failed passage of the first house by January 31 of the second year of the session; AB 83 failed passage in Senate Appropriations.

PROGRAM HISTORY/BACKGROUND

Prior to its sunset in 1992, California law provided a nonrefundable low-income tax credit of an amount ranging from 20% to 100% of the "computational tax," as defined, based on the taxpayer's adjusted gross income (AGI). The AGI amounts were indexed annually by the FTB. The "computational tax" was defined as the regular tax less all nonrefundable tax credits. This low-income tax credit could only be taken after all other allowable credits, except refundable credits.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Alan Hunter for GHG	4/5/00
____ SA	____ O	____ NAR		
____ N	____ OUA	__X__ PENDING		

SPECIFIC FINDINGS

Existing federal law allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

The **federal** credit for the 1999 taxable year is determined as follows:

Eligible Individual with	Earned Income	Completely Phased-out @	Credit %	Maximum Credit
1 qualifying child	$6,800	$26,928	34	$2,312
2 or more qualifying children	$9,500	$30,580	40	$3,816
no qualifying children	$4,500	$10,200	7.65	$347

Workers cannot claim the federal EIC if their 1999 investment income (such as interest and dividends) is more than $2,350. The amount of the federal EIC is reduced by the AMT, if any.

Existing federal law specifies that if the federal EIC was denied and IRS determined that error was due to reckless or intentional disregard of the federal EIC rules, the EIC will not be allowed for the next two years. If the error was due to fraud, then the EIC will not be allowed for the next ten years.

Existing federal law allows an eligible individual to receive advance payment of the EIC by providing his or her employer with a Form W-5. Taxpayers who receive advance payments of the EIC must file an income tax return. Any advanced payments that exceed the allowable EIC are recaptured. While EIC recipients may pay little or no income tax, allowing the EIC to be received through advance payments offsets the burden of social security and other payroll taxes.

Under provisions of federal law (Title IV of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193)), certain aliens are ineligible for federal, state and local public benefits, including the EIC. IRS implementation of Title IV is limited to verifying eligibility on the basis of Social Security numbers. The IRS delays all returns claiming the federal EIC that do not pass an automated Social Security number verification process. By its terms, this federal law applies to states.

Existing state law provides various personal credits to taxpayers that may reduce (but not below zero) their state income tax. Existing state law does not provide an EIC. Existing state law provides general rules that apply to the division of credits among two or more taxpayers, a husband and wife, and partners.

State law provides a personal exemption credit of $72 for each taxpayer, plus an additional exemption credit for those individuals who are 65 or older or are blind, and an exemption credit of $227 for each dependent. These amounts are for 1999 and are increased annually for inflation.

Under **state law,** individuals who make less income than the filing thresholds are not required to file an income tax return since the standard deduction and personal exemption credit would eliminate any tax liability. For 1999, these filing thresholds are $10,899 in gross income or $8,719 in AGI for single taxpayers and $21,798 in gross income or $17,438 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents. These thresholds also are increased annually for inflation.

This bill would provide a refundable EIC in an amount equal to 15% of the earned income credit (prior to its reduction by AMT) allowed by federal law. The amount of state EIC would be reduced by AMT, if any. Any state credit in excess of the state tax liability would be credited against other amounts due, and the balance would be refunded to the taxpayer.

This bill specifies the proposed EIC would be refunded to the taxpayer only if funds are appropriated for that purpose by the Legislature.

This bill would provide that the FTB shall train and inform employers regarding how employees may make withholding adjustments to reflect the credit.

This bill specifies that no credit shall be allowed to any of the following:

1) Any person who is treated as a nonresident for any portion of the taxable year;
2) Any person who is married and files a separate return for the taxable year; or
3) Any person who does not have a "qualifying child," as defined by the federal EIC specifications, for the taxable year.

This bill specifies that the federal allowance of advanced payment of earned income credit provided through additional employer payments shall not apply. However, **the bill** would allow for the adjustment of withholding to reflect the credit.

This bill would include the refundable EIC in the list of credits that can reduce regular tax below TMT.

This bill also adds the refundable EIC to the Revenue and Taxation Code (R&TC) provisions specifying when interest starts to accrue on overpayments.

Constitutional Consideration

This bill would disallow the EIC to any person treated as a nonresident for any portion of the taxable year, which may raise constitutional discrimination concerns by virtue of the credit being available only to individuals who are residents.

Policy Considerations

The IRS has experienced a significant number of invalid and fraudulent returns with the refundable federal EIC. According to the Financial Audit Report to the Secretary of the Treasury for Fiscal Year 1999, of the 573,000 tax returns claiming $1.25 billion in federal EIC (chosen through a screening process of 19.8 million EIC claims), $1.08 billion (86%) were invalid.

Implementation Considerations

This bill would require an appropriation of money by the Legislature to pay for this credit. Disallowance of the credit to some taxpayers could result if the amount of credits claimed exceeds the funds appropriated. Prior to approval of a continuous appropriation, refunds of the refundable renters' credit were delayed and interest had to be paid to taxpayers until more funds were appropriated to cover claims in excess of the initial appropriation. If funds are not available to cover refunds due, this would result payments of interest to refund recipients and in departmental costs associated with additional calls to the service center inquiring about delayed refunds.

Many taxpayers eligible for the federal EIC probably have little or no federal or state tax liability and do not have a California filing requirement. Some 500,000 current nonfilers would be required to file tax returns to claim the proposed EIC, which would significantly impact the department’s programs and costs.

The EIC is interpreted to be a state public benefit under federal law. As a public benefit, the proposed credit falls under the federal provisions making certain aliens ineligible for state public benefits. To establish eligibility, the claimant must declare himself/herself to be a citizen of the United States or an eligible alien. The FTB has no method in place to easily verify eligibility and the volume of claims anticipated is large.

The proposed credit under this bill would be claimed by low-income taxpayers with at least one qualifying child. Low-income taxpayers with a qualifying child generally file their tax returns on forms 540A or 540-2EZ. To add the EIC and accommodate the citizenship declaration, ten lines must be added to forms 540, 540A and 540NR (the 540NR has been included due to the constitutional issue). The 540-2EZ cannot accommodate ten lines because of to the reduced size of the form; therefore, taxpayers currently filing on the 540-2EZ would be required to file a 540A to claim the proposed EIC. Changes to these tax forms would result in a significant impact on the department's operations and costs. Moreover, because the proposed California EIC would be available only to those individuals with a qualifying child, California taxpayers would not be able to claim the proposed California EIC using TeleFile.

The IRS completes tax returns for some taxpayers who claim the refundable EIC. Since the proposed California EIC would be based on a percentage of the federal EIC, these taxpayers may expect the FTB to calculate their proposed California EIC. The FTB does not have access to the federal modified adjusted gross income figures (non-taxable and taxable earned income) that are used for the federal EIC calculation; therefore, the FTB would be required to request after the filing season and store additional documentation on these taxpayers. This would result in additional departmental costs.

Refund returns generally are filed early in the filing season. If taxpayers claiming the California EIC file late in the filing season after they receive their federal EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds.

Taxpayer error rate on the federal EIC and fraud concerns cause the IRS to adjust many returns. Consequently, the correct federal EIC amount may not be known until after the taxpayer has filed the state return and claimed the proposed California credit. The FTB would then have to issue an assessment to retrieve incorrect refunds. This would result in additional departmental costs.

This bill would require the FTB to provide training and information directly to employers; however, the Employment Development Department (EDD), rather than FTB, advises employers on matters relating to withholding. If such information could be provided indirectly through FTB's normal methods for providing information to tax preparers and taxpayers (i.e., instructions with tax forms, the Tax News newsletter) or through EDD advisories, this provision would not cause significant implementation issues. If this department were required to contact all employers in the state, significant resources would be required to implement this provision. Clarification is needed before the department could implement this portion of the bill.

Under specific provisions of federal law, denial of the EIC is treated as a deficiency, subject to protest and appeal. The bill does not specify protest and appeal rights in connection with denial of the proposed California EIC. It is unclear when denial of the state EIC would be subject to protest and appeal.

It is unclear if taxpayers would be ineligible for the state credit because of reckless or intentional disregard of the rules or because of fraud in claiming the state credit as provided under federal law.

Technical Consideration

Amendment 1 is provided to remove an obsolete reference to the refundable renters' credit.

FISCAL IMPACT

Departmental Costs

First year implementation costs are estimated at $13.9 million and ongoing costs are estimated at $11 million per year. This estimate considers satisfying the federal requirements and assuring that aliens are eligible for public benefits. The estimate also includes $1.2 million and $1 million respectively for additional leased facilities.

The estimated costs are associated with the printing and processing of an estimated 540,000 new filers who currently do not have a filing requirement, but would file solely to claim the refundable EIC. The costs also include processing of an estimated 3.25 million current filers who would qualify to claim the credit.

The addition of the EIC and the citizenship declaration to the tax forms and instructions would cause some forms to expand to another page and the instruction booklet to require a different binding to accommodate the estimated additional six pages of instructions. The additional page of the tax return would significantly slow the processing of all returns.

Since the IRS allows taxpayers to claim the credit and have the IRS calculate the amount, it is unlikely that FTB would know whether the federal credit was allowed, reduced, or denied before processing the state return. Because the FTB would not have access to federal data (e.g., non-taxable amounts included in modified AGI for this credit), the FTB would be unable to calculate the credit for federal or state purposes. In order to avoid the risk of paying interest on the refund created by the credit the department would be required to issue a refund without verifying the status of the federal EIC. If the FTB were able to obtain the federal information during the filing season, computer processing systems would have to be modified to calculate both the federal and state credit.
.
In addition, because of the fraud potential associated with any refundable credit, all returns filed solely for the EIC would be reviewed. A quality review (or second review) would be performed on 45% of those returns.

Other costs include changes to the computer systems that currently do not contain logic to process a refundable credit, increased taxpayer phone calls and correspondence, and electronic and paper storage. The department has no additional space to expand its current operations. The department would work within available space to the extent possible; however, this bill would require significant amounts of additional building space to process this credit, which may include leasing additional office space and file storage space.

Significant costs may be generated if the department has to collect erroneously issued refunds due to fraud or federal EIC adjustments.

Departmental costs associated with providing training and information to employers cannot be determined until this provision has been clarified.

Tax Revenue Estimate

This bill is estimated to result in revenue loses under the PITL as shown in the following table.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 1999 Enactment Assumed After June 30, 2000 $ Millions		
2000-01	2001-02	2002-03
-$595	-$607	-$622

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact for this bill will be determined by the number of qualifying taxpayers that have a dependent and the amount of earned income on which the credit is based.

These estimates were derived from the Department's Personal Income Tax Model and grown by the U.S. Treasury growth rates specifically for the federal earned income credit.

BOARD POSITION

Pending.

Analyst	Jeff Garnier
Telephone #	845-4786
Attorney	Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1854
As Amended March 23, 2000

AMENDMENT 1

On page 8, line 12, strike "or subdivision (j) of Section 17053.5"